THE RELATIONS OF STATE AND FEDERAL FINANCE.

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THE existence of several concurrent or overlapping tax jurisdictions has always been a source of more or less difficulty. It is especially, however, in federal states that the problem assumes its most acute form, and it is primarily in recent years that the complications have been vastly increased by the new developments of economic life. The problem is not peculiar to the United States, for the relations of local and imperial finance have long agitated the minds and taxed the abilities of British statesmen; while in federal states like Germany, Switzerland, Canada and Australia we have, as in the United States, the threefold complications of local, state and federal fiscal adjustments. The problems are with slight variations everywhere analogous.

In the United States it is only of late that the difficulties have presented themselves in full force. Local expenditures were at first of slight importance; State revenues were derived from tacking on an addition to the well-nigh sole source of local revenue—the general property tax; Federal revenues were by constitutional arrangement and by well-settled custom restricted, as a rule, to import duties and to a few categories of internal revenue taxation. Of late years, however, a threefold change has occurred. In the first place, the growing inadequacy of State and local revenues has led to the selection of new sources of income, some of which were also occasionally utilized by the Federal government. Secondly, the vast economic changes which have broken down State lines and made industry national have disclosed to a great degree the inherent weaknesses of certain forms of State taxation, and have led to the demand for some method of national

supervision or regulation in order to secure uniformity. In the third place, the well-nigh complete failure of the general property tax in State and local finance and the growing belief that large fortunes are evading their share of the public burdens has engendered a wide-spread demand for some more effective method of reaching the wealthier classes of the community. These three causes have conspired to bring the subject of the relations of State and Federal finance to a focus, so that it is now in the forefront of popular interest.

It behooves us, therefore, to give careful attention to this topic, and to endeavor to ascertain whether there do not exist some underlying principles of wide-spread application which may serve as a guide to the legislator and the administrator.

Looking at the subject in its largest aspect, it may be stated that there are at least three general considerations which must be borne in mind in the attempt to make a permanent choice of revenues for each of the competing tax jurisdictions. These are, respectively, the considerations of efficiency, of suitability and of adequacy. Let us take these up in turn.

The problem of efficiency in taxation is naturally of vital importance. No matter how well intentioned a scheme may be, or how completely it may harmonize with the abstract principles of justice, if the tax does not work administratively it is doomed to failure. It is clear that the effectiveness of different taxes depends upon the nature of the tax as well as upon the character of the administration. A tax on land, for instance, is apt to be best administered by local authorities; for it is, after all, the local assessors who may be presumed to possess the most exact knowledge of the local conditions upon which the value of the land depends. State supervision may, indeed, be desirable for certain purposes, but into that question we do not propose here to enter. In the main a locally administered land tax will be relatively efficient.

Other taxes are less obviously local in character or are less well fitted for local assessment because of administrative difficulties. A good example, for instance, is to be found in the liquor-license tax known in New York as the Excise Tax. When the assessment of the tax was transferred a few years ago from local to State officials, the effectiveness of the administration was so enhanced as vastly to increase the revenue. The administration was

removed from local politics, but was not plunged into State politics. Centralization of administration here, as in many other domains of political life, has been found to approve itself to the popular mind.

Just as the State-administered revenues have been found in some cases to be superior to locally administered revenues, it may be expected that Federally administered revenues will in some cases be superior to State-administered revenues. For not only is the Federal administration in some respects superior in efficiency to that of the State, but the very character of the tax may render effective supervision far easier in the one case than in the other. The administration of the income tax, for instance, would undoubtedly be far more effective in the hands of the Federal government than in those of the State government because of the difficulty, as we shall see, of localizing and adequately controlling incomes. Other instances of this distinction between administrative efficiency and inefficiency might be multiplied.

The second consideration is that of suitability. Are there any sources of revenue which are naturally more suitable for utilization by one tax jurisdiction rather than another? This is really a problem as to the basis of taxation. Is the basis of a given tax wide or narrow? Obviously in proportion as the basis of a tax is more and more extended the argument in favor of its utilization by the broader tax jurisdiction becomes correspondingly strong. Thus one of the principal reasons, in addition to that previously mentioned, why the tax on real estate is not employed by the central government is because the basis is so narrow a one. It is chiefly because the tax on real estate is unsuitable for the general revenue system that it is everywhere becoming more and more relegated to the local jurisdictions. This tendency is universal throughout the civilized world, and the seeming counter-tendencies which are illustrated by some of the proposals in the new British budget could easily be explained away for entirely different reasons. So far as the relations between State and Federal finance at all events are concerned, there is no doubt that a tax on real estate is obviously unfitted for the Federal government. We in the United States have had but three instances of such a tax, of an entirely ephemeral nature, and in the main so unsuccessful that its repetition is exceedingly doubtful.

While real estate, with its narrow basis, stands at one extreme of the scale, we find at the other extreme, with a very wide basis, articles of general consumption. The widest possible basis is afforded by commodities of so-called mass consumption, like tobacco and spirituous beverages; and we accordingly find that in the United States, as everywhere else, taxes on these commodities are reserved for the use of the broadest tax jurisdiction. Almost without exception the American States have voluntarily refrained from utilizing this source of revenue because of the obvious unsuitableness of these taxes on consumption for State purposes. The same is true to a still greater extent of customs duties, which are almost everywhere kept for national or Federal use. So strongly were these conditions of suitability present in the minds of our forefathers that the American Constitution not only expressly reserves the employment of import duties to the Federal government, but provides in effect that the indirect tax should be uniform throughout the country. It is clear that this desirable uniformity would be completely lost if the separate States were to arrogate to themselves this important source of revenue.

The problem of suitability, however, with its considerations of wide *versus* narow basis, has become of special importance to us in connection with three great classes of revenue—the corporation tax, the inheritance tax and the income tax. In each of these cases various reasons, as we shall see, have conjoined to put them forward as desirable constituents of a Federal tax system; but it is beyond question that one of the controlling factors in this demand is the proven unsuitability, from some essential points of view at least, of this tax for State purposes. This is due, above all, to the existence of interstate complications and to the fact that the economic basis of each of these three taxes is a wide one, while the State administrative basis is a narrow one.

With reference to corporations this statement scarcely needs any further proof. There are, indeed, still to be found many small businesses in corporate form supplying primarily local needs. But the striking characteristic of modern business life is the existence of corporations whose products are consumed throughout the country and whose very location, as in the case of the transportation companies, is interstate in character. From the economic point of view, interstate lines have been completely broken down, and the attempt to elaborate a successful system

of State taxes on corporations has been frustrated in large measure by the existence of these interstate complications. It is well known, for instance, that the new national tax on corporations is due almost exclusively to the endeavor to secure an adequate and uniform administrative supervision of corporations. As a purely fiscal measure the new tax is open to almost every conceivable objection.

The corporation tax is, for instance, repugnant to the principles of accounting, because it deducts taxes before arriving at taxable net earnings, a proceeding as little justifiable as would be a State tax on corporations which deducted from the taxable basis the locally assessable taxes, or *vice versa*. It is repugnant to the principles of justice in taxation in that it provides for the deduction of all sums payable as interest on bonded indebtedness. This practically means that the tax is a tax only on the stockholder and not on the bondholder. Why the man who invests $10,000 in railroad stock should pay taxes and another who invests $10,000 in bonds should go scot-free has never yet been shown. The old argument that the bond represents indebtedness while the stock represents property is, as every student knows, of no economic weight. It is a legal and not an economic consideration. Economically the mortgage is a part of the property; the stock and bonds together constitute the property, the stock being worth so much the less because of the existence of the bonds. If the real intent of the tax was to reach the people who owned the property there would be no justification in taxing only the class of property-owners known as bondholders. The legal situation is not the economic situation. The exemption of bondholders may, indeed, be necessary as a result of the judicial decisions on the income tax; but the economic consequence is lamentable in the extreme in causing the corporation tax to remain a torso.

Finally, thirdly, even if the intent is to reach only the stockholders, the corporation tax is repugnant to sound principles of finance. For, as is familiar to all students, a special tax on a particular class of capital invested in corporations will lead to a so-called amortization of the tax—that is, the market value of the corporate shares will fall by an amount equivalent to the capitalized value of the tax, so that the future purchaser of corporate shares will have bought them free of the tax, discounting

future taxes in the lower purchase price of the security. Thus the burden of the corporation tax will be borne by present stockholders, leaving future stockholders free.

From all these points of view, therefore, the Federal corporation tax might be declared to be violative of sound economic and fiscal principles. Nevertheless, all these objections are beside the mark, because the real intent of the tax is not fiscal, but social or regulative. It was because of the failure of the States adequately to regulate interstate corporations that this tax was devised. As a revenue-producer or even as a fiscal measure, it is lamentably inadequate, but as a regulative measure it is pregnant of the most far-reaching beneficial results. Whether a satisfactory scheme of regulating large corporations can be attained through a purely fiscal measure may well be doubted. But since taxation can be, and often has been, utilized for social and regulative purposes, it may well be expected that one regulative side of the corporation tax will serve as an entering-wedge to a more effective system. Thus the national corporation tax is a natural, not undesirable, consequence of existing interstate complications.

In the same way the demand for a Federal inheritance tax is in large measure the result of interstate conflicts of tax jurisdiction. Any one who has taken the trouble to follow with care the working of the inheritance tax in our foremost commonwealths will realize that as a revenue-producer it would be far more successful were it not subject to the difficulties of interstate conflicts of tax jurisdiction. The fact that the English inheritance tax yields about twenty times as much as the New York inheritance tax cannot be explained simply by the difference in population or in the tax rate. It is in large measure due to the fact that the Englishman cannot evade the tax as can the New-Yorker by transferring himself or his property to adjacent States where no such tax exists. On the other hand, there have been in America frequent instances of double taxation, as in the well-known case of the estate of a man, whose property happens to be situated in another State, being taxed by each State in turn. Thus the State assessment of inheritances means now undertaxation and now overtaxation—the net result being glaring inequality. From this point of view a Federal inheritance tax would be as superior to a State inheritance tax as the latter would be to a local inheritance tax.

The same considerations, but in an intensified form, applies to the income tax. If there is anything that may be considered a well-settled induction from experience, it is that an income tax is more and more unsuccessful as the basis of the tax becomes narrower. In former times a local income tax was fairly workable because incomes were chiefly local in their nature. In modern times, however, the income of the taxpayer, and especially the income of the larger taxpayer, has very little to do with the locality in which he happens to live. Nay, more, incomes nowadays, through the working out of economic forces, have become national and international in character and at all events have far transcended State lines. A man may live in one State and may secure his income partly from real-estate holdings situate in another State and partly from investments in securities of corporations whose earnings are derived in many other States. How is it possible for any local or State administration successfully to ascertain or adequately to control such income of its resident citizens? The State income taxes in the United States are largely for that reason the veriest farces, and under present economic conditions can never become anything else. If we are to have an income tax of any kind that is at all in consonance with fiscal principles, it must obviously be a Federal income tax rather than a State income tax. For in no other practicable way shall we be enabled to avoid the numberless complications of interstate double taxation which would assuredly render nugatory any attempt to introduce a State income tax.

It will be seen, therefore, that so far as concerns the question of suitability, resting on the existence of conflicts of tax jurisdictions the arguments in favor of Federal corporation, inheritance and income taxes, are of considerable weight. It would, however, be rash to conclude that the argument is convincing; for there still remains the third point, adverted to above, without a careful consideration of which no final conclusion can be reached. We come, in other words, to the principle of adequacy in taxation.

If we look at revenue measures from the point of view of adequacy, it will be seen that the problem assumes a different form. Let us apply it first to the income tax.

So far as considerations of revenue are concerned, it can scarcely be contested that the income tax is unnecessary for Federal purposes. Federal revenues in the past have in normal times

been derived almost entirely from custom duties and internal indirect taxes. There is no reason why these sources should not suffice for the future. Without entering here upon the general question of the protective tariff, it may be confidently asserted that we can continue to secure a large and growing revenue from import duties whether the principle of protection be upheld in its integrity or not. Either a revenue tariff with incidental protection or a protective tariff with incidental revenue can be made to yield the desired income. And when we consider the immense population in the United States, it is beyond all question that even a simple system of indirect taxes will suffice to raise the remainder of the needed revenue. The internal revenue, exclusive of the income tax, yielded at the close of the Civil War almost $300,000,000 a year, and if we take into account the prodigious increase in wealth and in consumption during the forty years that have elapsed, it will be apparent that the internal revenue system of the United States might be made to yield to-day many hundred millions of dollars more than it actually does without even approaching the number of taxes or the rate of taxation that existed during the Civil War. It is quite safe to say that so far as we can look into the future the prospective expenditure of the United States may be readily and easily supplied by import duties together with a well-chosen system of light internal revenue taxes.

A national income tax, therefore, is not needed for revenue purposes. Nor is the demand for a national income tax based upon such reasons. The argument in its favor, however, is none the less exceedingly strong. If not needed for revenue, it is needed for justice. This is due to the complete breakdown of the general property tax in State and local finance. Under the existing State and local systems there is no doubt that we are unable to reach the possessors of large fortunes. The wealthy man stands from under, not necessarily because he commits perjury, but because the loopholes in the general property tax have become so numerous that any adroit individual can avail himself of them. A Federal income tax is justifiable on the score of equity under prevalent American conditions.

I would here, however, sound a note of warning. It must not be imagined that a Federal income tax would at once work well. The experience of Germany and even of England must not lead

us astray. We have neither the administrative machinery of Prussia nor the methods of doing business which are found in Great Britain. The lump-sum, or direct, income tax of Prussia would be hopeless in this country; the schedule, or indirect, income tax of Great Britain would meet with great difficulties in its application here. It has taken England half a century to work out the problem of its income tax and to make it fairly successful. It would take us, perhaps, almost as long to make even a Federal income tax an administrative success. Thus those who hope for a fiscal or a social panacea in the Federal income tax are bound to be wofully disappointed. Moreover, if introduced into this country, an income tax measure must be framed with the most extreme care on the lines far different from those of 1862 and 1894.

One final advantage of the Federal income tax which must not be overlooked is that it would render far easier the struggle that is going on in our various States to amend or to abolish the iniquitous personal property tax. The taxation of intangible personalty has become a byword and a reproach to our American public life. All efforts to reform the system of the general property tax have thus far shattered against the rock of popular conviction that such wealth as consists of personal property ought not to be allowed to escape. If now we were to have a Federal income tax, however unsuccessful it might be at first, it would take the wind out of the sails of these objectors; and the would-be reformers of the system of local and State taxation would no longer be met by the contention that personal property must be listed for taxation. For personal property would then be reached through the Federal income tax. It is most significant that in Great Britain personal property was entirely exempted from all local taxation in the very same decade that the national income tax was imposed.

Our conclusion would then be that so far as the income tax is concerned, even though it be not needed for purposes of revenue, it is nevertheless a desirable adjunct to our scheme of Federal taxation. It goes, of course, without saying that even apart from this question the projected constitutional movement, legalizing the income tax, ought to prevail. For even if the income tax were not to constitute a part of our normal revenue system, it would be deplorable in the extreme if a mighty empire like

the United States were unable to use this potent engine of revenue in time of need.

When, however, we come to consider the inheritance tax and the corporation tax, we find that the argument from the principle of adequacy is somewhat different. The income tax is not employed, and is not needed, for State or local revenues; but the same is by no means true of the inheritance tax and the corporation tax. Every one who is familiar with the recent developments of tax reform in the American States knows that the tendency is very clear. There is an undoubted movement toward the separation of State and local revenues, with a reservation of the real-estate tax to the localities. On the fundamental reasons for this world-wide movement it is not necessary or proper here to enter, but it is pertinent to call attention to the fact that the general property tax is coming more and more to be restricted to the localities, and that the State governments have in consequence been compelled to reach out for new and independent sources of revenue. These new sources of revenue have consisted primarily of the corporation tax and the inheritance tax, supplemented in a few cases like New York by some other forms of taxation. In some States this process has been entirely completed, and the general property tax is no longer employed for State purposes, to the great advantage of all concerned. If now the Federal government were to seize upon either, or still worse, both the inheritance tax and corporation tax, this entire salutary movement would have to be checked. The assumption by the Federal government of what it does not need for fiscal purposes and of what is seriously needed by the State governments would be a calamity of the first magnitude—a calamity the full significance of which can be appreciated only by those who during the past few decades have patiently watched and labored to help in bringing about the beginning of the great reform which is now visible. The abandonment by the States of reliance on the aid afforded by the corporation tax and the inheritance tax is something that cannot be entertained for a moment.

On the other hand, as we have seen, both the inheritance tax and the corporation tax, like the income tax, are really better fitted for Federal administration. How, then, are we to escape these two horns of the dilemma? According to the principle of suitably the inheritance tax and the corporation tax should be

Federal taxes; according to the principle of adequacy they should be State taxes.

May I venture to suggest a method which will prevent us from being impaled on either of the two horns of the dilemma and which may extricate us from the difficulty? Why is it not possible to secure all the ends of suitability by having the taxes administered by the Federal government under general Federal laws, and why is it not possible to secure all the ends of adequacy by having the proceeds apportioned in whole or in part to the various States? This is my solution of the difficulty: let the national government assess the taxes and let the State governments profit by the taxes.

This is by no means so new or revolutionary a suggestion as it may appear. It is found in some form or other in many countries and in not a few of the American commonwealths. In England, for instance, the inheritance tax is assessed by the central government, but a part of the proceeds are allotted to the local governments. The same is true of some other taxes in England. In Germany the proceeds of certain indirect taxes are divided between the federal and the state governments, and one of the important features in the recent budgetary scheme of Chancellor von Bülow was to have a federally administered inheritance tax, a part of the proceeds to go to the states. This scheme has only temporarily been abandoned. In Canada it is well known that a large part of the provincial revenues is derived from the proceeds of taxes that are levied by the federal government. Other instances might readily be multiplied. In the United States also many of our separate commonwealths raise revenues which are apportioned to the local administration. Even the Federal government, as in the one famous instance of the Distribution of the Surplus, apportioned to the various States the proceeds of Federally assessed taxes. The question of the constitutionality of the scheme that I have suggested may be left to the lawyers. My own opinion, expressed with all diffidence, is that a constitutional method can be devised. But my additional opinion, expressed without any diffidence, is that if constitutional methods cannot be devised, the sooner a constitutional amendment is procured the better it will be. I can see no other avenue of escape from the complications that are looming up on all sides. It may, indeed, be claimed that the difficulties connected with

the conflicts of State jurisdiction can be overcome in another way—namely, by interstate agreements based on considerations of interstate comity, whereby each State will obligate itself to refrain from levying more than its equitable and proper share of the tax. While this consummation would be exceedingly desirable, it may well be doubted whether it is at all feasible. American experience has, unfortunately, driven home the lesson that the separate commonwealths cannot be depended upon voluntarily to relinquish any weapons which may constitutionally be employed in the struggle of local and sectional interests for economic advantage. Even if the majority of the States could be induced to enter into such a compact, the defection or refusal of a few States would be sufficient to defeat the whole scheme. In other federal states, like Germany, *e. g.*, it has been found necessary to achieve the desirable uniformity by imposing it upon the states through national regulation. It is clear, however, that the American commonwealths would not brook such national interference, and that the accomplishment of the desired end would require a constitutional amendment which it would be well-nigh impossible to secure.

Moreover, even if such interstate uniformity could be reached in this way, it would at best apply only to the inheritance tax. It would still fail to meet the problem involved in the corporation tax—the problem, viz., of reaching the corporate earnings derived exclusively or in large measure from interstate business. When even the economic apportionment to each State of its proper share of revenue from such complex sources is so difficult a matter to accomplish, the problem of the fiscal adjustment by purely State administrative methods may be declared to be well-nigh insoluble.

We are, therefore, forced back to the scheme suggested above as the sole practicable alternative. The method of Federal administration and State apportionment will accomplish everything that is needed. It will conform to the principles of efficiency and of suitability, because the taxes in question can best be administered by the Federal government and because in that way alone the gross inequalities of the present system can be overcome. While, on the other hand, the separate States will secure the revenues which they need and will be able to continue in the path of tax reform upon which they have so auspiciously entered.

Thus we reach the conclusion that of the three great taxes about which the controversy has now become so acute, the income tax ought to be levied by the Federal government and its proceeds utilized not only to diminish the burden of the national indirect taxes, but more especially in order to facilitate the reform of the State general property tax; and we reach the further conclusion that the corporation tax and the inheritance tax should be levied as national taxes by the Federal government, but under a clear understanding with the separate States that the proceeds should be distributed in whole or in greater part to them. To determine the exact methods of repartition would be comparatively easy. For that would be a matter of detail, not of principle. The important point is that some adjustment be reached whereby the legitimate demands of equality and of uniformity may be complied with without those of efficiency and adequacy being sacrificed. The interests of the States must at all costs be safeguarded, but the difficulties inherent in a State administration of what has become national in character must be avoided. The plan outlined above will accomplish this end. In this way, and probably in this way alone, can we do justice to the underlying principles of fiscal and social reform. In this way, and probably in this way alone, can the relations of State and Federal finance be put on an enduring and a completely satisfactory basis.

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